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Private Equity Co-Investing: Emerging Trends and Regulatory Developments

Goodwin Procter LLP

Michael D. Saarinen

1 Introduction

The private equity co-investment market has captured the attention of participants and regulators alike in recent years. Investor appetite for co-investments has been on the upswing, with a rising number of limited partners ("LPs") seeking to enhance their private equity portfolios by making deal-specific investments alongside traditional private equity funds.[1] In response to increasing demand, many general partners and other private equity fund sponsors (collectively, "GPs") have expanded their co-investment offerings and taken steps to foster co-investment relationships with strategic LPs.[2] The asset management landscape has been transformed, with co-investments now representing about 10% of total private equity assets under management.[3] The current period of growth in the co-investment market coincides with a time of intensified regulatory scrutiny of the private equity industry, a convergence that has made co-investment practices a focal point for the Securities and Exchange Commission ("SEC"). With the co-investment landscape in a state of flux, GPs that sponsor co-investment programs must remain alert to changing market and regulatory dynamics in order to achieve their business objectives.

This chapter is organized as follows. First, it briefly describes co-investing and the reasons for its rise to prominence. It then discusses the current regulatory environment and examines recent comments from the SEC regarding the allocation of co-investment opportunities. Finally, it concludes with a few questions about what may happen in the future.

2 Co-Investing in Context

Deal-by-deal co-investing

Although co-investing takes many forms, at present the most prevalent type of mediated co-investing involves a GP of a blind-pool private equity fund ("primary fund") offering selected LPs an opportunity to invest in a portfolio company alongside the primary fund on a one-off basis through a single-asset co-investment fund. LPs who participate in a co-investment fund receive exposure to a specific portfolio company, often with reduced or waived management fees and performance fees.

Features. A typical co-investment fund:

- is controlled by the GP; and
- relies on the GP (not the LPs) to source, acquire, manage and dispose of its investment.[4]

Purpose. Co-investment funds are often raised when:

- the primary fund's available capital is in short supply (e.g. during its fundraising period or when nearing the end of its investment period); or
- the size of the target opportunity is inappropriate for the primary fund (e.g., when the scale of the investment would (a) create risks that outweigh the benefits to the primary fund or (b) cause the primary fund to exceed its contractual concentration restrictions).

The decline of "club deals" and the rise of co-investing: a brief history

As recently as the early 1990s, many considered co-investing a "niche market."[5] What explains its relatively rapid rise in popularity? One contributing factor appears to have been GP dissatisfaction with "club deals," arrangements in which multiple private equity firms would band together to acquire large target opportunities. Club deals lost favour among some GPs in part due to concerns about potential allegations of collusion.[6] In addition, many club deals suffered governance difficulties during the global financial crisis due to disagreements within GP club groups.[7] The financial crisis also escalated club deal concerns among LPs, many of whom were exposed to the same poorly-performing assets across multiple portfolio funds due to overlapping deals.[8] The result was an environment in which: (a) GPs, deprived of club deal capital, needed the funding that LPs could provide in order to continue making large acquisitions, and (b) LPs, stung by the downturn and still suffering the consequences of unintended portfolio concentration, wanted lower-fee investment options and greater deal-by-deal control over at least a portion of their portfolios.

As the co-investment trend took shape, commentators noted that it represented a fundamental shift in the funding ecosystem: a model in which transactions were led by a consortium of experienced non-affiliated GPs was supplanted by a model in which the same acquisitions were made by a single GP alongside its existing or prospective clients, many of whom had less expertise than a typical GP.[9]

The benefits of co-investing

The factors that initially catalysed the co-investment trend, along with an assortment of other appealing characteristics, sustained the popularity of co-investing after the financial crisis had subsided. Industry observers have cited a range of potential benefits that may accrue to GPs and LPs when they co-invest with one another.

For GPs, co-investing may:

- boost buying power to close large deals;
- spread risk without diluting control;[10]
- reduce reliance on banks for financing;
- serve as a carrot to attract commitments at a primary fund's first closing;
- attract large LPs seeking differentiated products;
- deepen working relationships with strategic LPs;[11]
- defuse LP pressure to reduce primary fund fees;
- keep funds below the Employee Retirement Income Security Act's "common control group liability" threshold;[12]
- add additional points of view to help evaluate prospective investments; and[13]
- allow carried interest to be taken on a deal-by-deal basis.

For LPs, co-investing may:

- diminish blended expenses due to reduced or waived management fees and performance fees;[14]
- provide improved expense transparency;[15]
- enable rapid deployment of capital, unaccompanied by ongoing drawdown obligations;[16]
- provide greater flexibility for dynamic management of exposures and risks;
- offer opportunities to develop in-house expertise by working alongside a GP;
- generate favourable returns (under the right circumstances);
- improve understanding of a GP's investment process;
- encourage GPs to develop more consistent and robust due diligence procedures;[17] and
- provide an outlet to deploy excess dry powder alongside a trusted GP.[18]

3 Private Equity: Evolving U.S. Regulatory Climate

The era of SEC registration

In recent years, the co-investment market – along with the rest of the private equity industry – has felt the shockwaves of profound regulatory change.[19] Since the passage of the Dodd-Frank Act in 2010, private equity firms have been required to register with the SEC under the Investment Advisers Act of 1940 ("Advisers Act"). Previously, most private equity GPs operated largely outside the view of the SEC.[20] The transition to widespread registration ushered in a new era of intense SEC scrutiny of the industry. The SEC's Office of Compliance Inspections and Examinations ("OCIE") conducted a multi-year examination initiative focused on gathering information about the internal operations of a broad cross-section of newly-registered GPs, in some cases making referrals to the SEC's Division of Enforcement for investigation and possible enforcement action. Compliance has become a critical concern for private equity GPs, with the industry now carefully monitoring SEC developments in order to anticipate and address hot-button issues.

4 SEC Spotlight on Allocation of Co-Investment Opportunities

Co-investing conflicts: an overview

The SEC's statements on private equity matters have emphasized a central theme of the Advisers Act: the importance of identifying conflicts of interest and then either eliminating them or at least mitigating and disclosing them.[21] Areas of potential co-investing conflicts include:

- *Allocation of expenses.* For example, a GP may have incentives to allocate co-investment transaction expenses between a primary fund and co-investment funds in ways that benefit the GP.
- *Allocation of co-investment opportunities.* For example, a GP may have incentives (a) to allocate an excessive amount of an investment opportunity to a co-investment fund, reducing the primary fund's participation in a manner inconsistent with its best interest[22] or (b) to make primary fund investments to support a co-investment business.[23]

The SEC's actions involving co-investment expense allocations have recently generated a great deal of attention and commentary.[24] This chapter will examine the SEC's views on the allocation of co-investment opportunities, a topic that also merits further consideration.

Initial SEC commentary and market response

The SEC called attention to investment allocation issues several times in 2013 and 2014.

- *December 2013.* Andrew Bowden, then director of the OCIE, noted that "preferential treatment in the allocation of [...] co-investment opportunities for favored clients" would be an area of focus for OCIE examiners.[25]
- *January 2014.* OCIE published its examination priorities for 2014, which stated that the SEC staff would "conduct examinations focused on conflicts of interest" inherent in certain investment adviser business models, including conflicts involving "the allocation of investment opportunities."[26]
- *May 2014.* Andrew Bowden noted that recent presence exams found a deficit of "protocols for mitigating certain conflicts of interest, including investment and co-investment allocation."[27]

These statements, among others, led to speculation that the SEC might mandate specific formulas governing how co-investment opportunities are allocated among LPs. A few GPs feared a "nightmare" scenario in which all LPs are deemed to have an equal entitlement to co-investments.[28] Certain commentators on the LP side of the aisle made similar forecasts. For example, a 2015 Cambridge Associates report predicted "equal access for all LPs to co-investment opportunities, benefitting those with an established co-investment evaluation and approval process."[29] In addition, some observers suggested a GP's fiduciary duty might require that it give first priority co-investment rights to LPs in its primary fund unless it believes it is in their best interests to give such rights to third parties.[30]

Additional SEC commentary: downplaying formulas and emphasizing disclosure

Further comments from SEC staff helped address initial concerns about prescriptive allocation requirements.

- Concerns about a fiduciary duty to give LPs co-investment priority were addressed in January 2014, when Igor Rozenblit, then a private equity asset specialist in the asset management unit of the SEC's enforcement division, said, "A lot of people ask [...], 'what is my fiduciary duty to my investors with respect to co-investment allocation?' I'll give you my opinion [...] – I'm not sure there is one."[31]

- Fears of rigid allocation formulas were addressed in May 2015, when Marc Wyatt, then OCIE's acting director, expressly declined to assert that "an adviser must allocate its co-investments pro-rata or in any other particular manner."[32]

However, during those same presentations, Mr. Rozenblit and Mr. Wyatt also offered suggestions that, if followed, would cause significant changes in the co-investment allocation practices of many GPs.

- Mr. Rozenblit indicated that GPs may be obligated to disclose when and how co-investments are allocated among LPs. "You really need to disclose when the co-investments happen [...] you ought to tell them enough information and in a timely enough way so that if someone didn't get a co-investment opportunity you give them a chance to call you and complain," Mr. Rozenblit said.
- Mr. Wyatt recommended that GPs adopt "a robust and a detailed co-investment allocation policy which is shared with all investors," adding that "all investors deserve to know where they stand in the co-investment priority stack." Mr. Wyatt also warned against simply "disclosing less about co-investment allocation rather than more under the theory that if an adviser does not promise their investors anything, that adviser cannot be held to account" because "the risk in that approach is that such promises are often made anyway, either orally or through email."

Co-investment allocation disclosures: regulatory considerations

The staff's suggestions appear to have been intended, among other things, to help GPs comply with Rule 206(4)-8 of the Advisers Act ("Anti-Fraud Rule").[33] Adopted in 2007, the Anti-Fraud Rule extended GP liability to a much broader set of circumstances than were covered by preexisting regulations such as Rule 10b-5 of the U.S. Securities Exchange Act of 1934. For example, Rule 10b-5 only applies to statements made in connection with the purchase or sale of a security. In contrast, the Anti-Fraud Rule "prohibits advisers to pooled investment vehicles from making any materially false or misleading statements to investors in the pool *regardless of whether the pool is offering, selling, or redeeming securities*" (emphasis added).[34] Another key distinction is that an enforcement action under Rule 10b-5 requires both a false or misleading statement and the presence of scienter, whereas an action under the Anti-Fraud Rule only requires that an adviser acted negligently. Put differently, the SEC "does not need to show that the adviser acted with knowledge or intent to deceive, manipulate, or defraud."[35] One commentator observed that the Anti-Fraud Rule enables the SEC to bring a case against a GP "for making negligent oral misstatements or omissions [...] during a phone call with a potential investor who never decides to invest," adding, "[t]he rule requires [...] vigilance capable of preventing negligent oral disclosures made during meetings or phone calls."[36]

When viewed in this context, it becomes apparent that one benefit of a robust allocation policy is that it establishes clear ground rules for the allocation process, thereby reducing the odds that an allocation-related miscommunication by a GP might be characterized as a misleading statement for purposes of the Anti-Fraud Rule. In the absence of a robust allocation policy, there is a possibility that LPs could assign inappropriate significance to day-to-day allocation-related communications from GP personnel. Similarly, a policy of contemporaneously notifying LPs of each co-investment might reduce Anti-Fraud Rule risk by periodically revealing any misunderstandings that an LP may have developed about its co-investment allocation entitlement.

However, it should be noted that there are other effective ways for GPs to manage Anti-Fraud Rule risk that do not require that they sacrifice their ability to manage co-investment allocations in a flexible and private manner. For example, many GPs reduce the likelihood of allocation-related LP misunderstandings by providing LPs with upfront allocation disclosure rather than by means of ongoing notifications or rigid allocation policies.[37] Such disclosures typically state, among other things, that (1) a GP has full discretion over co-investment allocations (2) the default is that there are no LP co-investment rights, and (3) any LP co-investment rights must be formally granted. The advance disclosures may include a statement to the effect that an LP who desires to co-invest or cross-invest, but has not been granted specific co-investment or cross-investment rights, must assume that no such rights exist.

5 A Look Ahead

The co-investment market continues to evolve, raising a number of interesting questions to be answered in the years ahead:

- What further pronouncements (if any) will the SEC make on co-investment allocations?
- Will additional industry norms develop around co-investment offerings and disclosure, e.g., (i) offering process and timing, (ii) level of LP access to due diligence materials and counterparties, and (iii) marketing material content?
- Will the relative simplicity of hard-wired blind-pool co-investment funds (also known as "over-allocation funds" or "side-car funds") lead to a rise in their popularity?
- Will legal and regulatory developments lead to a revival of club deals?
- What steps will LPs take to enhance their co-investment capabilities? Will overall trends favour engagement with third-party consultants or the development of in-house talent?
- How will the growing body of co-investment performance data influence market activity?[38]

Although much remains uncertain, it is likely that investments outside of classic private equity fund structures will account for a growing share of private equity fundraising in 2016 and beyond. As more LPs gravitate toward non-traditional options such as co-investments, direct investments and separate accounts, the SEC's interest in this area of the private equity sector can be expected to persist.

Endnotes

1. *See generally* Liz Moyer, "More Foundations and Endowments Weigh Private Equity Co-Investments," *The New York Times* (21 October 2015). *See also* Jessica Duong, "The State of Co-Investments," *Prequin Private Equity Spotlight* (March 2014). ("[T]he vast majority (73%) of investors surveyed have [previously] co-invested [...] with 40% actively seeking co-investment opportunities at present and 37% doing so on an opportunistic basis.")
2. *See generally* Jose Camacho, Cyril Demaria and Dweep Chanana, "Tailored Direct Private Equity," *The Economist* (29 September 2015). ("[O]f 80 American fund managers surveyed [...], 64% offered co-investments and a further 19% were planning to.") *See also* "State of play: Co-investments in 2015," *Joining forces: The co-investment climate in private equity* (12 November 2015). ("PE firms are becoming increasingly hungry to offer LPs the chance to invest and are being more proactive.")
3. *Global Private Equity Report 2015*, Bain & Company, Inc. *See also* Monk, A.H.B., Sharma R., "Capitalizing on Co-

Investment Platforms," Global Projects Center, Stanford University (31 July 2015). ("[M]ore than 20% of all US buyout transactions undertaken since 2009 involved co-investments compared with less than 5% of buyouts for the same 5 year period leading up to 2008.")

4. *See generally* "Prequin Special Report: Real Estate Co-Investment Outlook," (March 2016). ("Syndicated co-investments, whereby a fund manager sells down a portion of equity to select LPs after a deal has been completed, are the most prevalent type of co-investments.")

5. "Co-investment in clover," *Unquote* (October 2014). *See also* "Excellence in Co-Investment," Transcript, *Privcap* (1 September 2011).

6. One antitrust lawsuit was brought against 11 large private equity firms in 2007 and came to an end in 2014 after running up $590.5 million in total settlement costs. *See generally* William Alden, "Carlyle Deal Concludes a Lawsuit Against Private Equity," *Deal Book – The New York Times* (8 September 2014). *See also* Jeremy W. Dickens "The Evolving Private Equity Market: Changing Players and Concerns," *Understanding Legal Trends in the Private Equity and Venture Capital Market* (2015 Edition). ("[Co-investment] transactions are likely to continue [...] given the sensitivity of many sponsors to the large amounts paid to settle the 'collusion' lawsuits.")

7. *See generally* "Excellence in Co-Investment", Transcript, *Privcap* (1 September 2011). ("As soon as there is a little hiccup, you have four bosses at the table and it's very difficult to move as nimbly, and exert the control that they need to really move the company forward.") *See also* Arleen Jacobius, "Co-investing deals blazing a comeback," *Pensions and Investments* (4 March 2013).

8. *See generally* Peter Fogel, "Party's Over: Why PE Firms Are No Longer Clubbing," *PitchBook* (23 April 2014). ("One of the main reasons for why LPs would rather directly co-invest with specific funds is that [...] the risk isn't spread across several of its investments.") However, some in the industry believe that criticisms of club deals for causing LP overexposure were "misplaced." *2005 Private Equity Roundtable Recap*, Ropes & Gray (16 May 2005).

9. *See generally* Michael Flaherty, "Buyout firms find ways around club deals," *Reuters Edge* (20 February 2007).

10. *See generally* Bob O'Brien, "Behind the push toward co-investing," *The Deal* (4 December 2015). ("[I]t's a way for GPs to lay off some of their risk.")

11. *See generally*, "Is the appetite for private equity co-investment a healthy one?" *Financier Worldwide* (June 2015).

12. In 2013, the First Circuit Court of Appeals held that a private equity fund was engaged in a "trade or business" under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). *Sun Capital Partners III, LP v New Eng. Teamsters and Trucking Indus. Pension Fund*, 724 F.3d 129 (1st Cir. 2013). The decision was significant because it meant that the fund could be liable for the pension plan liabilities of its portfolio company unless the fund's "controlled group" interest in the portfolio company remained below ERISA's 80% ownership threshold. At the time of the decision, it was generally believed that investments by a primary fund and a co-invest fund would be siloed rather than aggregated for purposes of such 80% threshold. See generally "Commentary: How GPs are blocking pension liabilities," PE Manager Weekly (14 January 2013). However, further uncertainty was introduced due to a subsequent decision by the U.S. District Court for the District of Massachusetts that aggregated two related funds for purposes of such threshold. Sun Capital Partners III, LP v. New Eng. Teamsters & Truckers Indus. Pension Fund, 2016 WL 1239918 (D. Mass., 28 March 2016). At the time of writing, the long-term consequences of the decision are uncertain. Some observers predict an increase in the use of arrangements involving unrelated investors, such as club deals, in order to keep multiple funds of the same sponsor below the 80 percent ownership threshold.

13. *See generally* Julia Corelli, "Best practices in structuring co-investments," *The Legal Special 2013 – A Private Equity International Supplement* (April 2013). ("Requiring a high ability to independently assess a coinvestment opportunity is a risk mitigation strategy.")

14. *See generally* "Aligning Interests: The Emergence of Hedge Fund Co-Investment Vehicles," JP Morgan (First Quarter 2014). ("[Co-investment] fee reductions may in turn result in improved economics for investors since the J-curve impact from the main private equity fund is mitigated.")

15. *See generally* Brian Lee and Garrett Black, "Direct and coinvestment by LPs on the Rise" *PitchBook*, 18 September 2015. ("[A]s calls for greater transparency into fee structures grow ever more strident [...] LPs may well push for such increased involvement in investing as a way to better track performance.")

16. The absence of a long-term commitment is notable when compared to the current trend toward slower disposition of assets by private equity funds. *See generally* "Fact: GPs Hold LPs' Investments Longer" Interview with David Wachter, *Privcap* (2014).

17. *See generally* Jeremy W. Dickens, "The Evolving Private Equity Market: Changing Players and Concerns," *Understanding Legal Trends in the Private Equity and Venture Capital Market* (2015 Edition). ("[O]ne of the trends we observe is toward much more thorough (and time consuming) financial, accounting, technical, and legal due diligence on the part of sponsors.")

18. There is currently a great deal of dry powder on the sidelines. *See e.g. Global Private Equity Report 2016*, Bain & Company, Inc. ("[U]ninvested dry powder today stands at a record $1.3 trillion.")

19. *See generally* Bruce L. Lieb, "Raising a Private Equity Fund: Current Terms," Panel Remarks, Sixteenth Annual Private Equity Forum (July 2015). ("The public criticism of private equity over the past year [...] has been scathing and unprecedented [...]. The SEC clearly intends to shake the industry out of any sense of complacency, and it's been quite effective in doing that.")

20. *See generally* Chairman Mary L. Schapiro, Testimony Concerning the State of the Financial Crisis Before the Financial Crisis Inquiry Commission (14 January 2010). ("[P]rivate funds and many of their advisers currently are outside the purview of the SEC and other regulatory authorities, and we have no detailed insight into how [private fund advisers] manage their trading activities, business arrangements or potential conflicts of interest.")

21. *See generally* Julie M. Riewe, Division of Enforcement, Securities & Exchange Commission, "Conflicts, Conflicts Everywhere," Speech (26 February 2015). ("The Supreme Court in SEC v. Capital Gains Research Bureau, Inc. stated that Congress [...] intended 'to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice which was not disinterested.'")

22. Incentives for a GP to allocate co-investment opportunities to its co-investment funds may include: (i) co-invest fund economic interest held by GP personnel, (ii) superior co-invest fund GP economics (e.g., deal-by-deal carry) and (iii) GP relationships with strategic co-investment participants.

23. *See generally* SEC Presentation, Compliance Outreach Program National Seminar (30 January 2014). ("Issue: Favoring certain clients or funds or favoring certain investors without proper disclosure. Examples: [...] Primary investments made to support a secondary or co-investment business.")

24. *See e.g.*, "SEC Charges KKR With Misallocating Broken Deal Expenses," SEC Press Release (29 June 2015).
25. "RCA Symposium Offers Perspectives from Regulators and Industry Experts on 2014 Examination and Enforcement Priorities, Fund Distribution Challenges, Conducting Risk Assessments, Compliance Best Practices and Administrator Shadowing (Part Two of Three)," *The Hedge Fund Law Report* (19 December 2013).
26. SEC National Examination Program Priorities 2014 (9 January 2014).
27. Andrew J. Bowden, SEC Office of Compliance Inspections and Examinations, "Spreading Sunshine in Private Equity," Speech (6 May 2014).
28. Dawn Lim, "Firms Say New SEC Scrutiny May Further Complicate Co-Investments," *The Wall Street Journal* (25 July 2014). ("[N]ot all of a firm's clients seek out co-investment rights in the first place. 'To have to go out to everybody would be a nightmare.'")
29. Andrea Auerbach, Priya Pradhan, Christine Cheong and Rohan Dutt, "Making Waves: The Cresting Co-Investment Opportunity," Cambridge Associates (March 2015).
30. See Lily Chang, "Co-Investments in the Hedge Fund Context: Fiduciary Duty Concerns, Conflicts and Regulatory Risks," *The Hedge Fund Law Report* (7 March 2014). ("[I]f a manager could have offered a co-investment opportunity to a fund investor or a non-fund investor and offered the opportunity to the latter, the manager should be able to articulate a reason for the choice that is consistent with the interests of the fund investor.")
31. Igor Rozenblit's remarks at the 2014 Compliance Outreach Program National Seminar (30 January 2014).
32. Marc Wyatt, SEC Office of Compliance Inspections and Examinations, "Private Equity: A Look Back and a Glimpse Ahead," speech at the Private Equity International Private Fund Compliance Forum (13 May 2015). *See also* Igor Rozenblit's remarks at the 2016 Compliance Outreach Program National Seminar (19 April 2016). ("People always ask, 'Is it okay to differentiate between investors? Is it okay to allocate to my large investors? Is it okay to allocate to investors that have a broader relationship with our advisor?' And I think the answer is, all of that is okay if it's properly disclosed.")
33. The written presentation that accompanied Mr. Rozenblit's remarks specifically noted that inadequate co-investment allocation disclosure could cause a breach of the Anti-Fraud Rule. In addition, the Anti-Fraud Rule adopting release states that it can be used to address inappropriate allocations of investment opportunities. *See* SEC Release No. IA-2628, "Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles" (3 August 2007) ("The new rule prohibits, for example, materially false or misleading statements regarding [...] practices the adviser follows in the operation of its advisory business such as *how the adviser allocates investment opportunities*") (emphasis added).
34. *See* SEC Release No. IA-2628, "Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles" (3 August 2007).
35. Barry P. Barbash & Jai R. Massari, "The Investment Advisers Act of 1940: Regulation by Accretion," *Rutgers Law Journal* (2008) ("The Rule's reach appears to be virtually unlimited in terms of the written materials prepared by, and conduct engaged in by, advisers that could be prohibited under the Rule.")
36. Mark A. Berube, "New SEC Antifraud Rule: Utmost Tool in Subprime Crisis?" *New York Law Journal*, (30 July 2008).
37. SEC staff have recently characterized allocation policies and procedures as a "vehicle" for disclosure. *See* Igor Rozenblit's remarks at the 2016 Compliance Outreach Program National Seminar (19 April 2016). ("[H]aving good policies and procedures is a really good vehicle to properly disclose exactly how you're going to allocate co-investments.")
38. *See generally* Ayesha Javed, "Co-investing is best for private equity performance," *Financial News* (13 November 2015). *See also* "Pritzker Group's Carbone pours cold water on co-investing," *Buyouts* (25 June 2014).

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